

*Opening Doors for Generations*



# FARMERS BANK

*Annual Report 2013*

COURTEOUS | PROMPT | RELIABLE | SECURE

# Our Mission

It is the mission of Farmers Bank to be unique and distinct from all other financial institutions, set apart by excelling in the following areas:

To offer a superior level of service that is responsive, courteous, cooperative and professional.

To remain an independent financial institution close to the people of Isle of Wight County, Southampton County, the City of Suffolk and the surrounding communities, being sensitive to their financial needs and designing and offering products to specifically meet those needs.

To be good corporate citizens, serving as leaders to strengthen our communities and promote their welfare.

To employ men and women who are loyal to the bank and committed to our direction, policies and goals.

To bring our shareholders a fair rate of return on their investments.





## Dear Shareholder,

During the past several years your Board of Directors, Management and Staff were committed to making Farmers Bank healthier, stronger and well positioned for the future. We accomplished this goal by concentrating on credit quality and working diligently to lower classified and non-earning assets. During 2012 we deleveraged our balance sheet of low yielding investments that were offset with high costs deposits and borrowings.

We are pleased to inform you that these strategies were effective and have increased your shareholder value through improved core earnings during 2013. Net income, excluding extraordinary items surpassed those in 2012 by \$400,000 or seventeen percent. While loan growth was essentially flat, problem loans were replaced with higher quality credits. Average non-interest bearing deposits grew almost sixteen percent, helping to lower our cost of funds. As many financial institutions have experienced tighter net interest margins, ours has expanded by almost thirty basis points through actions taken at the end of 2012 and into 2013.

As previously disclosed in our letter to shareholders earlier this year, all outstanding preferred stock to the U.S. Treasury's Capital Purchase Program was repaid on December 31, 2013. This repayment and the approximately \$11 million in capital notes issued at the holding company level has positioned us for growth and expansion in 2014 and beyond.

As your Board of Directors and Management shift our focus to strategic planning for the future we are eager and motivated. We have a management team that is dedicated to customer service and technology going forward. We will strive to offer products and services that are convenient, useful and dependable. We have been opening doors for generations through long term customer relationships within our communities and understand that the Bank is successful when our customers are successful. Our Board of Directors, Management and Staff are active and invested in the communities in which we serve and are driven to promote and encourage our customers.

Kindly accept my sincere thanks for your loyalty and continued support of Farmers Bank. Your core business, involvement in our service communities and promotion of the bank provide a base for stability and growth. You, our owners, are an asset that we do not take for granted and again we express our deep appreciation.

Sincerely,



Richard J. Holland Jr.

*Chairman and Chief Executive Officer*

*Farmers Bank  
is healthier,  
stronger and  
well positioned  
for the future.*



# Board of Directors



Richard J. Holland, Jr.  
*Chairman*



William A. Gwaltney, Jr.  
*Vice Chairman*  
*Indika Farms, Inc., President*



G. Thomas Alphin, Jr.  
*Commonwealth Gin,*  
*Co-Owner*



Harold U. Blythe  
*Retired Bank CEO*



William L. Chorey  
*Chorey & Associates Realty, Ltd.,*  
*Owner/Broker*



E. Dana Dickens, III  
*Hampton Roads Partnership,*  
*Retired President & CEO*



David T. Owen  
*Wakefield Farm Service, Inc.,*  
*President*



Peter D. Pruden, III  
*Taste Unlimited, Co-Owner*



William H. Riddick, III  
*Attorney at Law - Smithfield*



Kent B. Spain  
*Suffolk Insurance Corporation,*  
*Executive Vice President*



O. A. Spady  
*Retired Entrepreneur*

# Executive Management



Richard J. Holland, Jr.  
*Chairman of the Board &  
Chief Executive Officer*



Vernon M. Towler  
*President &  
Chief Lending Officer*



Patricia T. Allen  
*Senior Vice President,  
Director of Loan Administration*



Kathy C. Bryant  
*Senior Vice President,  
Director of Human Resources*



Norman F. Carr, Jr.  
*Senior Vice President,  
Smithfield Market*



Kristy E. DeJarnette  
*Senior Vice President,  
Chief Financial Officer*



Shirley B. Robinson  
*Executive Secretary*

# Bank Officers

William N. Bailey

*Vice President, Information Technology*

Lauren P. Harper

*Vice President, Loans*

Elizabeth D. Jones

*Vice President, Loans*

Clayton N. Minter

*Vice President, Chief Credit Officer*

William D. Pollard, Jr.

*Vice President, Loans*

Chad A. Rountree

*Vice President, Windsor Market*

H. Hadley Whitlock, Jr.

*Vice President, Loans*

Susan B. Williamson

*Vice President, Compliance*

Thomas L. Woodward, III

*Vice President, Suffolk Market*

Andrea B. Curry

*Assistant Vice President, Operations*

Kelly D. Dewitt

*BSA, AML, OFAC & Security Officer*

Blanche E. Hecker

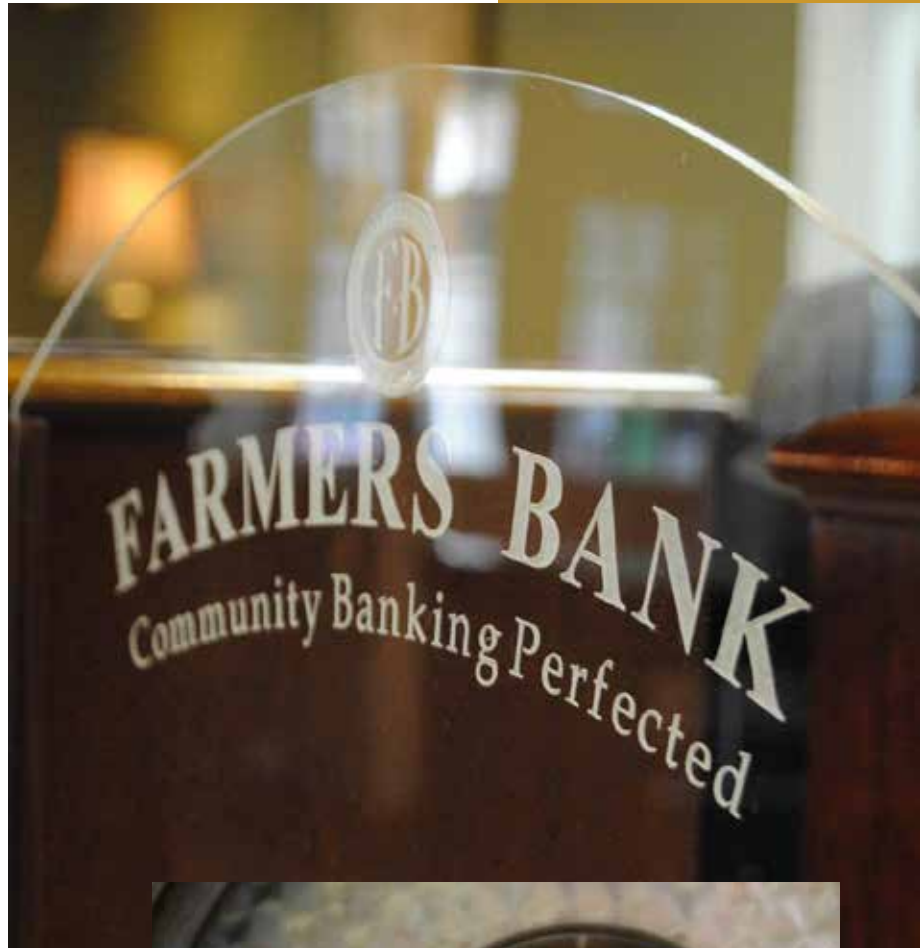
*Assistant Vice President, Retail*

Joanne F. Joyner

*Assistant Vice President, Retail*

Erin W. Park

*Assistant Vice President, Controller*



# Suffolk Community Board



*Pictured left to right:*

Timothy K. Palmer

*Attorney at Law & Certified Public Accountant*

Christie New Craig

*Vice Chairman of the Chesapeake School Board and Chief of Staff for Delegate John Cosgrove*

Alison Dodson Anderson

*Owner, A. Dodson's*

David E. Russell (Chairman)

*President, Tile & Terrazzo, LLC*

*Not Pictured:*

James C. Adams, III

*President, Featherlite Coaches*



# Financial Highlights

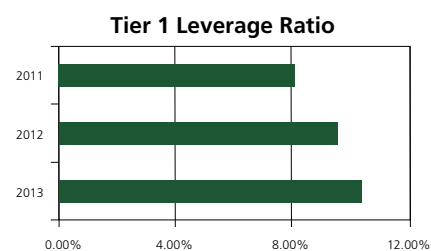
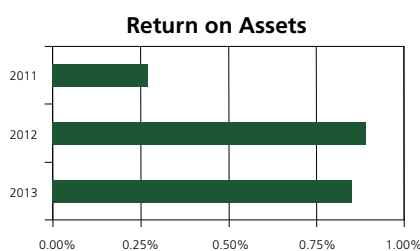
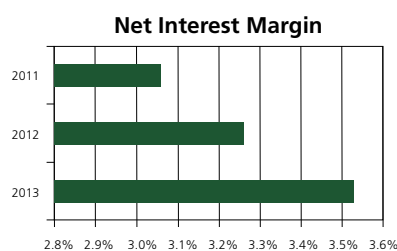
At or for the Years Ended December 31,	2013	2012	2011
		(Dollars in thousands, except per share data)	
<b>Summary of Operations</b>			
Interest income	\$15,909	\$17,371	\$19,618
Interest expense	3,182	4,900	6,655
Net interest income	12,727	12,471	12,963
Provision for loan losses	(500)	0	3,965
Net interest income after provision for loan losses	13,227	12,471	8,998
Non-interest income	1,337	3,381	2,793
Non-interest expense	10,150	10,811	10,336
Income before income taxes	4,414	5,041	1,455
Income taxes	1,098	1,310	239
Net income	\$3,316	\$3,731	\$1,216
<b>Per Share and Shares Outstanding (1)</b>			
Basic net income	\$4.66	\$5.22	\$1.11
Book value at end of period	\$54.06	\$55.85	\$43.67
Basic weighted average shares outstanding	607,357	605,821	605,399
Shares outstanding at period end	608,020	607,366	606,658
<b>Balance Sheet Data</b>			
Total assets	\$412,162	\$392,343	\$423,729
Total loans, net	221,843	220,402	223,422
Total deposits	343,350	325,680	341,713
Borrowings	20,000	20,000	40,000
<b>Selected Performance Ratios</b>			
Return on average assets	0.85%	0.89%	0.27%
Return on average stockholders' equity	8.30%	9.00%	3.30%
Net interest margin (2)	3.53%	3.26%	3.06%
Non-interest income as a percentage of total revenue (3)	9.50%	21.33%	17.72%
Efficiency ratio (4)	69.16%	70.89%	69.38%
<b>Asset Quality Ratios</b>			
Nonperforming loans to period-end loans	2.45%	2.13%	2.71%
Allowance for loan losses to period-end loans	3.22%	3.68%	3.80%
Net charge-offs to average loans outstanding	0.23%	0.17%	2.17%
<b>Capital (Bank Only)</b>			
Tier 1 leverage ratio	10.37%	9.55%	8.09%
Total risk-based capital ratio	18.40%	17.51%	15.89%
Stockholder's equity	\$43,104	\$42,992	\$39,290

(1) Computed based on the weighted average number of shares outstanding during each period.

(2) Net interest margin is net interest income divided by average interest earning assets.

(3) Total revenue consists of net interest income and non-interest income.

(4) Efficiency ratio is non-interest expense divided by the sum of net interest income and non-interest income.



# Farmers Bankshares, Inc.

## Consolidated Financial Statements for Years Ended December 31, 2013 and 2012

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**DIXON HUGHES GOODMAN** LLP  
Certified Public Accountants and Advisors

## **Independent Auditors' Report**

To the Board of Directors and Shareholders  
Farmers Bankshares, Inc.  
Windsor, Virginia

We have audited the accompanying consolidated financial statements of Farmers Bankshares, Inc. which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditors' Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers Bankshares, Inc., as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Dixon Hughes Goodman LLP*

Charlotte, North Carolina  
February 20, 2014

**Farmers Bankshares, Inc.**  
**Consolidated Balance Sheets**

	December 31,	
	2013	2012
<b>Assets</b>		
Cash and cash equivalents		
Cash and due from banks	\$ 20,986,999	\$ 15,001,762
Federal Funds sold	10,523,685	4,448,861
<b>Total cash and cash equivalents</b>	<b>31,510,684</b>	<b>19,450,623</b>
Available-for-sale securities (Note 3)	140,293,318	135,547,857
Loans, net of allowance for loan losses		
of \$7,381,066 and \$8,423,052, respectively (Note 4)	221,842,775	220,402,341
Premises and equipment, net (Note 5)	5,038,166	4,749,080
Other real estate owned	1,788,798	1,178,212
Accrued interest	1,796,866	1,831,195
Prepaid expenses	388,920	674,806
Income taxes receivable	213,466	346,296
Net deferred tax asset	1,056,385	-
Non-marketable equity securities (Note 6)	2,256,089	2,506,839
Bank-owned life insurance	5,844,964	5,608,421
Other assets	131,718	47,657
	380,651,465	372,892,704
<b>Total assets</b>	<b>\$ 412,162,149</b>	<b>\$ 392,343,327</b>
<b>Liabilities and Stockholders' Equity</b>		
Deposits		
Noninterest-bearing deposits	\$ 71,039,645	\$ 57,260,973
Interest-bearing deposits (Note 7)	272,310,842	268,419,434
<b>Total deposits</b>	<b>343,350,487</b>	<b>325,680,407</b>
Federal Home Loan Bank borrowings (Note 9)	20,000,000	20,000,000
Capital notes (Note 8)	11,253,475	-
Securities sold under agreements to repurchase (Note 9)	2,595,776	1,747,780
Deferred compensation plans	971,455	753,184
Net deferred tax liability	-	261,546
Other liabilities	886,085	582,382
Accrued interest	234,354	325,585
<b>Total liabilities</b>	<b>379,291,632</b>	<b>349,350,884</b>
<b>Stockholders' equity</b>		
Non-cumulative perpetual preferred stock (Series A), no par value, 8,752 shares authorized, issued and outstanding at December 31, 2012	-	8,632,556
Non-cumulative perpetual preferred stock (Series B), no par value, 438 shares authorized, issued and outstanding at December 31, 2012	-	457,271
Common stock, \$0.625 par value; 10,000,000 shares authorized; 608,020 and 607,336 shares issued and outstanding at December 31, 2013 and 2012, including nonvested shares of -0- and 420 shares, respectively	380,015	379,323
Capital surplus	2,695,613	2,652,804
Retained earnings	28,853,472	26,360,240
Accumulated other comprehensive income	941,417	4,510,249
<b>Total stockholders' equity</b>	<b>32,870,517</b>	<b>42,992,443</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 412,162,149</b>	<b>\$ 392,343,327</b>

**Farmers Bankshare, Inc.**  
**Consolidated Statements of Operations**

	Years Ended December 31,	
	2013	2012
<b>Interest income</b>		
Interest and fees on loans	\$ 12,103,930	\$ 13,112,991
Interest on available-for-sale securities	2,559,424	3,096,712
Interest on tax exempt available-for-sale securities	1,163,005	1,086,221
Interest on federal funds sold	22,270	11,067
Other interest income	60,225	64,402
<b>Total interest and dividend income</b>	<u>15,908,854</u>	<u>17,371,393</u>
<b>Interest expense</b>		
Interest on deposits	2,690,428	3,849,221
Interest on Federal Home Loan Bank advances	485,607	1,042,622
Interest on repurchase agreements	5,366	4,073
Interest on federal funds purchased	469	3,914
<b>Total interest expense</b>	<u>3,181,870</u>	<u>4,899,830</u>
<b>Net interest income</b>	12,726,984	12,471,563
<b>Provision (recovery) for loan losses</b>	<u>(500,000)</u>	<u>-</u>
<b>Net interest income after provision for loan losses</b>	<u>13,226,984</u>	<u>12,471,563</u>
<b>Noninterest income</b>		
Service charges	345,983	349,856
Gain on disposition of securities	109,232	1,367,954
Gain on sale of premises and equipment	-	842,513
Other income	881,539	820,634
<b>Total noninterest income</b>	<u>1,336,754</u>	<u>3,380,957</u>
<b>Noninterest expense</b>		
Salaries and employee benefits	5,421,728	5,028,703
Equipment expense	657,278	675,422
Occupancy expense	594,080	526,765
Bank franchise tax	381,498	320,857
Advertising and marketing	381,409	298,086
Data processing	772,958	790,131
Loan related legal and other expenses	169,653	350,808
Federal Deposit Insurance Corporation assessment	291,640	338,193
Loss on sale and write-downs of other real estate owned	120,919	574,623
Prepayment penalty on borrowings	-	557,523
Other	1,358,861	1,349,860
<b>Total noninterest expense</b>	<u>10,150,024</u>	<u>10,810,971</u>
<b>Income before income taxes</b>	4,413,714	5,041,549
<b>Income tax expense (Note 11)</b>	<u>1,097,970</u>	<u>1,310,234</u>
<b>Net income</b>	3,315,744	3,731,315
Preferred stock dividend and accretion of discount	488,399	570,257
<b>Net income attributable to common shareholders</b>	<u>\$ 2,827,345</u>	<u>\$ 3,161,058</u>
<b>Basic earnings per common share (Note 18)</b>	<u>\$ 4.66</u>	<u>\$ 5.22</u>
<b>Diluted earnings per common share</b>	<u>\$ 4.66</u>	<u>\$ 5.22</u>
<b>Cash dividends declared per common share</b>	<u>\$ 0.55</u>	<u>\$ 0.52</u>

The accompanying notes are an integral part of these consolidated financial statements.

**Farmers Bankshares, Inc.**  
**Consolidated Statements of Comprehensive Income**

	Years Ended December 31,	
	2013	2012
<b>Net income</b>	\$ 3,315,744	\$ 3,731,315
<b>Other comprehensive income (loss):</b>		
Unrealized holding gains (losses) on available-for-sale securities	(5,298,090)	2,464,244
Tax effect	1,801,351	(837,843)
Unrealized holding gains (losses) on available-for-sale securities, net of tax amount	(3,496,739)	1,626,401
Reclassification adjustment for realized gains	(109,232)	(1,367,954)
Tax effect	37,139	465,104
Reclassification adjustment for realized gains, net of tax amount	(72,093)	(902,850)
Other comprehensive income (loss), net of tax	(3,568,832)	723,551
<b>Comprehensive income (loss)</b>	\$ (253,088)	\$ 4,454,866

**Farmers Bankshares, Inc.**  
**Consolidated Statements of Changes in Stockholders' Equity**

	Preferred Stock Series A	Preferred Stock Series B	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
<b>Balances, December 31, 2011</b>	<u>\$ 8,520,487</u>	<u>\$ 476,103</u>	<u>\$ 378,636</u>	<u>\$ 2,613,991</u>	<u>\$ 23,514,208</u>	<u>\$ 3,786,698</u>	<u>\$ 39,290,123</u>
Net income	-	-	-	-	3,731,315	-	3,731,315
Changes in net unrealized gain on securities available for sale, net of reclassification adjustment and tax effect	-	-	-	-	-	723,551	723,551
Issuance of common stock - stock compensation plan	-	-	263	14,737	-	-	15,000
Issuance of common stock - director stock plan	-	-	424	24,076	-	-	24,500
Preferred stock net accretion, (amortization) and costs	112,069	(18,832)	-	-	(93,237)	-	-
Cash dividends declared on preferred shares	-	-	-	-	(477,020)	-	(477,020)
Cash dividends declared on common shares, \$0.52 per share	-	-	-	-	(315,026)	-	(315,026)
<b>Balances, December 31, 2012</b>	<u>8,632,556</u>	<u>457,271</u>	<u>379,323</u>	<u>2,652,804</u>	<u>26,360,240</u>	<u>4,510,249</u>	<u>42,992,443</u>
Net income	-	-	-	-	3,315,744	-	3,315,744
Changes in net unrealized gain on securities available for sale, net of reclassification adjustment and tax effect	-	-	-	-	-	(3,568,832)	(3,568,832)
Repurchase of preferred stock	(8,752,400)	(437,600)	-	-	-	-	(9,190,000)
Issuance of common stock - stock compensation plan	-	-	263	14,738	-	-	15,001
Issuance of common stock - director stock plan	-	-	429	28,071	-	-	28,500
Preferred stock net accretion, (amortization) and costs	119,844	(19,671)	-	-	(100,173)	-	-
Cash dividends declared on preferred shares	-	-	-	-	(388,226)	-	(388,226)
Cash dividends declared on common shares, \$0.55 per share	-	-	-	-	(334,113)	-	(334,113)
<b>Balances, December 31, 2013</b>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 380,015</u>	<u>\$ 2,695,613</u>	<u>\$ 28,853,472</u>	<u>\$ 941,417</u>	<u>\$ 32,870,517</u>

**Farmers Bankshares, Inc.**  
**Consolidated Statements of Cash Flows**

	Years Ended December 31,	
	2013	2012
<b>Cash flows from operating activities</b>		
Net income	\$ 3,315,744	\$ 3,731,315
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	448,786	438,944
Provision (recovery) for loan losses	(500,000)	-
Provision for deferred income taxes	520,557	406,105
Amortization of investment securities premiums	1,239,767	1,846,775
Net gain on disposition of available-for-sale securities	(109,232)	(1,367,954)
Loss on sales and writedowns on other real estate owned	120,919	574,623
Capitalization of costs associated with other real estate owned	(16,801)	-
Gain on sale of premises and equipment	-	(842,513)
Increase in cash value of bank owned life insurance	(236,543)	(210,442)
Compensation expense for stock issuance	15,001	15,000
Director expense for stock issuance	28,500	24,500
Change in operating assets and liabilities		
Interest receivable	34,329	163,749
Interest payable	(91,231)	(310,515)
Prepaid expenses	285,886	235,678
Income taxes receivable	132,830	209,127
Other assets	(3,061)	419,957
Deferred compensation	218,271	112,196
Other liabilities	133,457	69,183
<b>Net cash provided by operating activities</b>	<u>5,537,179</u>	<u>5,515,728</u>
<b>Cash flows from investing activities</b>		
Proceeds from sales, prepayments and maturities of available-for-sale securities	26,300,963	58,506,561
Purchase of available-for-sale securities	(37,584,280)	(21,471,125)
Proceeds from sale of non-marketable equity securities	254,200	947,200
Purchase of non-marketable equity securities	(3,450)	(4,800)
Proceeds from sale of other real estate owned	614,297	1,302,938
Loan originations, net of repayments	(2,350,434)	2,301,638
Proceeds from sale of premises and equipment	-	1,009,886
Purchases of premises and equipment	(737,872)	(364,492)
<b>Net cash provided by (used in) investing activities</b>	<u>(13,506,576)</u>	<u>42,227,806</u>
<b>Cash flows from financing activities</b>		
Cash dividends paid on preferred shares	(388,226)	(477,020)
Cash dividends paid on common shares	(163,867)	(315,026)
Repurchase of preferred stock	(9,190,000)	-
Proceeds from issuance of capital notes	11,253,475	-
Proceeds from FHLB borrowings	5,000,000	-
Repayment of FHLB borrowings	(5,000,000)	(20,000,000)
Change in noninterest-bearing deposits	13,778,672	6,837,359
Change in interest-bearing deposits	3,891,408	(22,870,054)
Change in securities sold under agreements to repurchase	847,996	812,268
<b>Net cash provided by (used in) financing activities</b>	<u>20,029,458</u>	<u>(36,012,473)</u>
<b>Net increase in cash and cash equivalents</b>	12,060,061	11,731,061
<b>Cash and cash equivalents</b>		
Beginning of the year	<u>19,450,623</u>	<u>7,719,562</u>
End of year	<u>\$ 31,510,684</u>	<u>\$ 19,450,623</u>



**Farmers Bankshares, Inc.**  
**Consolidated Statements of Cash Flow (concluded)**

	Years Ended December 31,	
	2013	2012
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for		
Income taxes	\$ 460,000	\$ 695,000
Interest on deposits and other borrowings	3,273,101	5,210,345
 <b>Supplemental schedule of non-cash investing activities</b>		
Change in unrealized gains on available-for-sale securities, net of income tax	\$ (3,568,832)	\$ 723,551
Transfer of loans to other real estate owned	(1,410,000)	(781,166)
Contribution of other real estate owned	(81,000)	-

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 1 - Organization and nature of business

Farmers Bankshares, Inc. (the "Company") was organized and incorporated under the laws of the Commonwealth of Virginia on July 26, 2013. On December 31, 2013, the Company was consummated as the Bank Holding Company of Farmers Bank, Windsor, Virginia (the "Bank") through a reorganization plan, under the laws of the Commonwealth of Virginia. As of this date, the Bank became a wholly-owned subsidiary of Farmers Bankshares, Inc. The Bank was formed on November 12, 1919 and has offices in Windsor, Smithfield, Suffolk, and Courtland, Virginia. Through its banking subsidiary the Company provides a wide variety of banking services primarily in southeastern Virginia.

The Bank provides small and mid-sized businesses, professionals, corporate executives and entrepreneurs with banking services comparable to those of the large national and regional institutions. These services include loans that are priced on a deposit-based relationship, direct access to the Bank's decision makers, and quick, innovative response to customers' financial needs. If customers have credit requirements that exceed the Bank's credit limits, the Bank seeks to accommodate those customers by arranging loans on a participation basis with other financial institutions.

### Note 2 - Summary of significant accounting policies

*Basis of presentation and consolidation* - The consolidated financial statements of the Company are prepared in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, the Bank and FB Properties of Virginia, L.L.C., which owns certain Bank assets. All significant intercompany balances and transactions have been eliminated in consolidation.

*Cash and cash equivalents* - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with banks and federal funds sold, all of which mature within 90 days or less. The Company is required by the Federal Reserve to maintain average reserve balances. For the final quarterly reporting period in 2013 and 2012, the aggregate amount of daily-required balances was \$46,000 and \$19,000, respectively.

*Investment securities* - Investments in debt securities classified as held-to-maturity, if any, are stated at cost, adjusted for amortization of premiums and accretion of discounts using the interest method. The Company held no such securities during the periods reported in the financial statements.

Investments in debt securities classified as trading, if any, are stated at fair value. Such securities are purchased and held principally for the purpose of selling them in the near term. Unrealized holding gains and losses for trading securities are included in the statements of operations. The Company held no such securities during the periods reported on in the financial statements.

Investments not classified as either held-to-maturity or trading are classified as available-for-sale. Debt securities classified as available-for-sale are stated at fair value with unrealized holding gains and losses excluded from earnings and reported as a component of accumulated other comprehensive income until realized. The income statement line items impacted by the reclassification of realized gains (losses) on the sale of securities are the gains (losses) on sales of securities and income tax expense line items in the income statement.

Gains and losses on the sale of securities are determined using the specific identification method and are recognized on a trade date basis. Other than temporary declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost, if any, are included in earnings as realized losses.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 2 - Summary of significant accounting policies (continued)

*Investment securities* (concluded) - In determining, whether other-than-temporary impairment exists, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) if the Company expects to recover the amortized cost basis in the security.

*Loans* - The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by commercial and consumer mortgage loans throughout Southeastern Virginia. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity generally are stated at their outstanding unpaid principal balances. Interest income is accrued on the unpaid principal balance for all loan classes. Discounts and premiums are amortized to income using the interest method. Net deferred fees and costs are amortized over the lives of the applicable loans using the effective interest rate method.

*Allowance for loan losses* - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of a specific, a historic and a qualitative, general component. The specific component relates to loans that are considered impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of an impaired loan are lower than the carrying value of that loan. The historic component covers non-classified and criticized loans and is based on historical loss experience adjusted for qualitative factors. The qualitative reserve of the allowance reflects adjustments to historical experience to account for current conditions impacting the loan portfolio.

For all classes, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The allowance model is applied to determine the specific allowance balance for impaired loans and the general allowance balance for unimpaired loans grouped by loan type.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 2 - Summary of significant accounting policies (continued)

*Allowance for loan losses (concluded)* - The Bank's loan charge-off policy for all loan classes is to charge down loans to net realizable value once a portion of the loan is determined to be uncollectible, and the underlying collateral shortfall is assessed. Loans are moved to nonaccrual status when the loan becomes 90 days delinquent or a portion of the loan is determined to be uncollectible and supporting collateral is not considered to be sufficient to cover potential losses. Nonaccrual loans are reviewed monthly to determine if all or a portion of the loan is uncollectible. Nonaccrual loans that are determined to be solely collateral dependent are monitored for possible charge downs to net realizable value upon determination that they are impaired.

*Income recognition on impaired and non-accrual loans* - All classes of loans are generally classified as non-accrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. All classes of loans that are on a current payment status or past due less than 90 days may also be classified as non-accrual, if repayment in full of principal and/or interest is in doubt.

All classes of loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

When all classes of loans are classified as non-accrual and the future collectibility of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the future collectibility of the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a non-accrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

*Other real estate owned* - Real estate acquired through, or in lieu of, foreclosure is held for sale and is initially recorded at fair value less estimated cost to sell at the date of foreclosure, establishing a new cost basis. Principal and interest losses existing at the time of acquisition of such assets are charged against the allowance for loan losses and interest income, respectively. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Revenue and expenses from operations associated with other real estate owned and the impact of any subsequent changes in the carrying value are included in other expenses.

*Premises and equipment* - Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. For financial reporting purposes, assets are depreciated over their estimated useful lives using the straight-line method. Useful lives for these assets are within the following ranges, buildings from 10-39 years, equipment, furniture and fixtures 3-15 years, computer equipment 3-7 years and software 3-5 years. For income tax purposes, the accelerated cost recovery system and the modified accelerated cost recovery system are used.

*Non-marketable equity securities* - Non-marketable equity securities are restricted securities, carried at cost, and periodically evaluated for impairment. These securities are restricted, do not have a readily determinable fair value, and lack a market. Because of the redemption provisions of the Federal Reserve Bank and Federal Home Loan Bank stock, the Bank estimated that the fair value equaled or exceeded the cost of these investments and the investments were not impaired.

*Income taxes* - Income taxes are provided for the tax effects of transactions reported in the financial statements, and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of investment securities, deferred loan fees, allowance for loan losses, deferred compensation, interest on non-performing loans and accumulated depreciation for financial and income tax reporting.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 2 - Summary of significant accounting policies (continued)

*Income taxes* (concluded) - Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered in income. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized. Management has evaluated all other tax positions that could have a significant effect on the financial statements and determined the Company had no uncertain income tax positions at December 31, 2013 and 2012. The years ending on or after December 31, 2010 remain subject to examination by federal and state tax authorities. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

*Deferred compensation plans* - The Company maintains deferred compensation and retirement arrangements with certain officers. The Company's policy is to accrue the estimated amounts to be paid under the contracts over the expected period of active employment. The Company purchased life insurance contracts to fund the expected liabilities under the contracts.

*Earnings per common share* - Basic earnings per share (EPS) are computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted earnings per share reflect the potential dilution if restricted stock, or other common stock equivalents, would result in the issuance of additional shares of common stock that share in earnings. Potential common shares that may be issued by the Company relate solely to outstanding non-vested restricted stock.

*Off-balance sheet financial instruments* - In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit, standby letters of credit, and financial guarantees written. Such financial instruments are generally recorded in the financial statements when they become payable. A reserve for these off-balance sheet financial instruments is considered immaterial as is the fair value of the financial guarantees.

*Use of estimates* - The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Estimation of fair values* - The following notes summarize the major methods and assumptions used in estimating the fair value of financial instruments:

Short-term financial instruments are valued at their carrying amounts included in the Company's balance sheet, which are reasonable estimates of fair value due to the relatively short period to maturity of the instruments. This approach applies to cash and cash equivalents, deposits in other banks, federal funds sold, and short-term borrowings.

Loans are valued on the basis of estimated future receipts of principal and interest, discounted at various rates. Loan prepayments are assumed to occur at the same rate as in previous periods when interest rates were at levels similar to current levels. Future cash flows for homogeneous categories of consumer loans are estimated on a portfolio basis and discounted at current rates offered for similar loan terms to new borrowers with similar credit profiles. A liquidity discount is not considered in determining the fair value of the loan portfolio.

Investment securities are valued at quoted market prices, if available. The fair value of equity investments in the restricted stock of the FRB and FHLB approximates the carrying value due to the redemptive provisions of these securities.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 2 - Summary of significant accounting policies (continued)

#### *Estimation of fair values (concluded) –*

For unquoted securities, the fair value is estimated by the Company on the basis of financial and other information.

The carrying amounts of accrued interest approximate fair value.

The fair value of demand deposits and deposits with no defined maturity is taken to be the amount payable on demand at the reporting date. The fair value of fixed-maturity deposits is estimated using discounted cash flow analyses and rates currently offered for deposits of similar remaining maturities. The intangible value of long-term relationships with depositors is not taken into account in estimating the fair values disclosed.

Fair values of capital notes are based on market prices for debt securities having similar maturity and interest rate characteristics. The impact of the Company's assessment of its own credit risk is not factored into the fair value of the notes.

The carrying amounts of federal funds purchased and borrowings under repurchase agreements approximate their fair values.

The fair values of the Company's Federal Home Loan Bank advances are estimated using discounted cash flow analyses based on current rates offered on similar debt instruments.

It is not practicable to separately estimate the fair values for off-balance-sheet credit commitments, including standby letters of credit and guarantees written, due to the lack of cost-effective, reliable measurement methods for these instruments.

*Certain significant estimates* - Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans and the valuation of other real estate owned. Management uses available information to recognize losses on loans and other real estate owned. Future additions to the allowances may be necessary based on changes in local economic conditions and other factors. Management believes the allowances recorded at December 31, 2013 and 2012 are sufficient to cover inherent losses in the portfolio.

*Recent accounting pronouncements* - In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the notes to the consolidated financial statements.

In January 2014, the FASB issued ASU 2014-4, "Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure". The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 2 - Summary of significant accounting policies (concluded)

*Recent accounting pronouncements* (concluded) - Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The adoption of this standard is not expected to have a material impact on the consolidated financial statements of the Company.

*Reclassifications* - Certain reclassifications have been made to prior period balances to conform to the current year presentation.

### Note 3 - Available-for-sale securities

At December 31, 2013 and 2012, securities are as follows:

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
State and municipal	\$ 35,063,849	\$ 871,128	\$ 276,408	\$ 35,658,569
Residential mortgage-backed securities	19,433,360	225,046	584,986	19,073,420
Collateralized mortgage obligations	46,669,105	408,420	786,817	46,290,708
Small Business Administration Pools	37,700,613	1,570,008	-	39,270,621
	<u>\$ 138,866,927</u>	<u>\$ 3,074,602</u>	<u>\$ 1,648,211</u>	<u>\$ 140,293,318</u>

December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
State and municipal	\$ 29,965,718	\$ 2,472,981	\$ -	\$ 32,438,699
Residential and mortgage-backed securities	15,559,345	575,618	-	16,134,963
Collateralized mortgage obligations	39,214,311	1,016,326	58,524	40,172,113
Small Business Administration Pools	43,974,771	2,827,311	-	46,802,082
	<u>\$ 128,714,145</u>	<u>\$ 6,892,236</u>	<u>\$ 58,524</u>	<u>\$ 135,547,857</u>

At December 31, 2013 and 2012, gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position, are as follows:

December 31, 2013	Approximate Market Value	Continuous Unrealized Losses Existing for:		Total Losses
		Less than 12 Months	More than 12 Months	
Available-for-sale securities:				
State and municipal	\$ 10,648,954	\$ 276,408	\$ -	\$ 276,408
Residential mortgage-backed securities	11,044,258	584,986	-	584,986
Collateralized mortgage obligations	20,991,354	776,449	10,368	786,817
Total temporarily impaired investment securities	<u>\$ 42,684,566</u>	<u>\$ 1,637,843</u>	<u>\$ 10,368</u>	<u>\$ 1,648,211</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 3 - Available-for-sale securities (continued)

December 31, 2012	Approximate Market Value	Continuous Unrealized Losses Existing for:		Total Losses
		Less than 12 Months	More than 12 Months	
Available-for-sale securities:				
Collateralized mortgage obligations	\$ 317,490	\$ 11,330	\$ -	\$ 11,330
Collateralized mortgage obligations	2,124,623	-	47,194	47,194
Total temporarily impaired investment securities	<u>\$ 2,442,113</u>	<u>\$ 11,330</u>	<u>\$ 47,194</u>	<u>\$ 58,524</u>

*State and municipal* - The Company's unrealized losses on state and municipal securities were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because of the Company's intent to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

*Residential and mortgage-backed securities and collateralized mortgage obligations* - The Company's unrealized losses on residential and mortgage-backed securities and collateralized mortgage obligations were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because our mortgage-related securities are backed by FNMA and FHLMC, which are GSEs, or are collateralized by securities backed by these agencies, and because of the Company's intent to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

At December 31, 2013 and 2012, securities with a carrying value of approximately \$17,016,641 and \$20,514,874, respectively, are pledged to the Commonwealth of Virginia to secure public deposits. In addition, at December 31, 2013 and 2012, securities with a carrying value of \$4,792,267 and \$4,214,038, respectively, are pledged to the Federal Home Loan Bank to secure advances. Investment securities with carrying values of \$3,213,431 and \$3,585,603 are pledged to secure repurchase agreements at December 31, 2013 and 2012, respectively.

At December 31, 2013, the amortized cost and fair value of debt securities by maturity date are as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -
Due from one to five years	193,631	199,012
Due from five to ten years	13,065,105	13,447,775
Due after ten years	125,608,191	126,646,531
Total debt securities	<u>\$ 138,866,927</u>	<u>\$ 140,293,318</u>

Gross realized gains on available-for-sale securities were:

	2013	2012
Residential mortgage-backed securities	\$ 109,074	\$ 462,214
Small Business Administration Pools	-	611,246
State and municipals	158	294,494
Total gross realized gains	<u>\$ 109,232</u>	<u>\$ 1,367,954</u>



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 3 - Available-for-sale securities (concluded)

There were no gross realized losses on available-for-sale securities during 2013 or 2012.

Proceeds from the sale of available-for-sale securities totaled \$4,878,319 and \$34,386,865 for the years ended December 31, 2013 and 2012, respectively.

### Note 4 - Loans and Allowance for Loan Losses

*General* - The Bank provides to its customers a full range of short- to medium-term commercial, agricultural, Small Business Administration guaranteed, mortgage, home equity, and personal loans, both secured and unsecured. The Bank also makes real estate mortgage and construction loans. At December 31, 2013 and 2012, loans consisted of the following:

	2013	2012
Mortgage loans on real estate:		
Construction	\$ 31,261,147	\$ 33,539,112
Commercial Real Estate:		
Non-owner occupied	34,726,441	33,056,579
Owner occupied	58,036,590	56,691,698
Residential 1-4 family	41,339,445	42,555,168
Multifamily	7,377,067	8,090,850
Equity lines of credit	11,425,387	10,428,101
Total mortgage loans on real estate	<u>184,166,077</u>	<u>184,361,508</u>
Commercial and industrial	23,072,880	23,652,191
Agricultural	19,659,415	18,536,728
Individuals	2,240,940	2,213,473
Total loans	<u>229,139,312</u>	<u>228,763,900</u>
Less: Allowance for loan losses	(7,381,066)	(8,423,052)
Net deferred loan fees and costs	84,529	61,493
Loans, net	<u>\$ 221,842,775</u>	<u>\$ 220,402,341</u>

*Real Estate Loans* - Real estate loans include construction and land development loans, commercial real estate loans, home equity lines of credit and residential mortgages.

Construction/development lending totaled \$31.3 million and \$33.5 million at December 31, 2013 and 2012, respectively. The Bank originates one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower) and provides financing to builders and consumers for the construction of pre-sold homes. The Bank generally receives a pre-arranged permanent financing commitment from an outside banking entity prior to financing the construction of pre-sold homes. The Bank also makes commercial real estate construction loans, primarily for owner-occupied properties. The Bank limits its construction lending risk through adherence to established underwriting procedures. Residential one-to-four family loans amounted to \$41.3 million and \$42.6 million at December 31, 2013 and 2012, respectively.

Commercial real estate loans totaled \$92.8 million and \$89.7 million at December 31, 2013 and 2012, respectively. This lending has involved loans secured by owner-occupied commercial buildings for office, storage and warehouse space, as well as non-owner occupied commercial buildings. The Bank generally requires the personal guaranty of borrowers and a demonstrated cash flow capability sufficient to service the debt. Loans secured by commercial real estate may be larger in size and may involve a greater degree of risk than one-to-four family residential mortgage loans. Payments on such loans are often dependent on successful operation or management of the properties.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 – Loans and Allowance for Loan Losses (continued)

*Commercial and Industrial Loans* - At December 31, 2013 and 2012, the Bank's commercial loan portfolio totaled \$23.1 million and \$23.7 million, respectively. Commercial loans include both secured and unsecured loans for working capital, expansion, and other business purposes. Short-term working capital loans are secured by accounts receivable, inventory and/or equipment. The Bank also makes term commercial loans secured by equipment and real estate. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. With few exceptions, the Bank requires personal guarantees and secondary sources of repayment. Commercial loans generally provide greater yields and re-price more frequently than other types of loans, such as real estate loans.

*Agricultural Loans* - Agricultural loans totaled \$19.7 million and \$18.5 million at December 31, 2013 and 2012, respectively and include loans secured by farm equipment, inventory and farm land. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. Payments on such loans are often dependent on successful operation or management of the farming operation.

*Loans to Individuals* - Loans to individuals (consumer loans) include automobile loans, boat and recreational vehicle financing, and miscellaneous secured and unsecured personal loans and totaled \$2.2 million at December 31, 2013 and 2012, respectively. Consumer loans generally can carry significantly greater risks than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Repossessed collateral securing a defaulted consumer loan may not provide an adequate source of repayment of the loan. Consumer loan collections are sensitive to job loss, illness and other personal factors. The Bank manages the risks inherent in consumer lending by following established credit guidelines and underwriting practices designed to minimize risk of loss.

*Loan Approvals* - The Bank's loan policies and procedures establish the basic guidelines governing its lending operations. The guidelines address the type of loans that the Bank seeks, target markets, underwriting and collateral requirements, terms, interest rate and yield considerations and compliance with laws and regulations. All loans or credit lines are subject to approval procedures and amount limitations. These limitations apply to the borrower's total outstanding indebtedness to the Bank, including any indebtedness as a guarantor. The policies are reviewed and approved at least annually by the Board of Directors of the Bank. The Bank supplements its own supervision of the loan underwriting and approval process with periodic loan reviews by independent, outside professionals experienced in loan review. Responsibility for loan review and loan underwriting resides with the Chief Credit Officer position. This position is responsible for loan underwriting and approval. On an annual basis, the Board of Directors of the Bank determines officers lending authority. Authorities may include loans, letters of credit, overdrafts, uncollected funds and such other authorities as determined by the Board of Directors.

Substantially all of the Bank's loans have been granted to customers in the Hampton Roads area of Virginia.

*Credit Review and Evaluation* - The Bank outsources the credit risk review function which reports to the Board of Directors. The focus of the engagement is on policy compliance and proper grading of higher credit risk loans as well as new and existing loans on a sample basis. Additional reporting for problem/criticized assets has been developed along with an after-the-fact loan review.

The Bank uses a risk grading program to facilitate the evaluation of probable inherent loan losses and the adequacy of the allowance for loan losses. In this program, risk grades are initially assigned by loan officers, reviewed by the Chief Credit Officer and reviewed by credit review analysts on a test basis. The Bank strives to maintain the loan portfolio in accordance with conservative loan underwriting policies that result in loans specifically tailored to the needs of the Bank's market area. Every effort is made to identify and minimize the credit risks associated with such lending strategies.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

*Credit Review and Evaluation* (concluded) - All loans are risk graded on a scale from 1 (highest quality) to 9 (loss). Acceptable loans at inception are grades 1 through 5. These grades have underwriting requirements that at least meet the minimum requirements of a secondary market source. If borrowers do not meet credit history requirements, other mitigating criteria such as substantial liquidity and low loan-to-value ratios could be considered and would generally have to be met in order to make the loan. The Bank's loan policy states that a guarantor may be necessary if reasonable doubt exists as to the borrower's ability to repay.

The Board of Directors has authorized the loan officers to have individual approval authority for risk grade 1 through 5 loans up to maximum exposure limits for each customer. New or renewed loans that are graded 6 (special mention) or lower must have approval from the Chief Credit Officer and Chief Lending Officer. Any changes in risk assessments as determined by loan officers, credit administrators, regulatory examiners and management are also considered.

The risk grades, normally assigned by the loan officers when the loan is originated and reviewed by the Chief Credit Officer, are based on several factors including historical data, current economic factors, composition of the portfolio, and evaluations of the total loan portfolio and assessments of credit quality within specific loan types. In some cases the risk grades are assigned by the Chief Credit Officer or the Chief Lending Officer, depending upon dollar exposure. Because these factors are dynamic, the provision for loan losses can fluctuate. Credit quality reviews are based primarily on analyses of borrowers' cash flows, with asset values considered only as a second source of payment. Credit analysts work with lenders in underwriting, structuring and risk grading the Bank's credits. The Chief Lending Officer and the Chief Credit Officer focus on lending policy compliance, credit risk grading, and credit risk reviews on larger dollar exposures. Management uses the information developed from the procedures above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in determining the appropriate levels of the allowance for loan losses. The following is a summary of the credit risk grade definitions for all loan types:

"1" – Prime - Credits in this category are virtually risk-free and are well-collateralized by cash or cash-equivalent instruments held by the Bank. The repayment program is well-defined and achievable, and repayment sources are numerous. No material documentation deficiencies or exceptions exist.

"2" – Good - This grade is reserved for loans secured by readily marketable collateral, or loans within guidelines to borrowers with liquid financial statements. A liquid financial statement is generally a financial statement with substantial liquid assets, particularly relative to the debts. These loans have excellent sources of repayment, with no significant identifiable risk of collection, and conform in all respects to Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).

"3" – Acceptable 1 - This grade is reserved for the Bank's top quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection. Generally, loans assigned this risk grade will demonstrate the following characteristics:

- Conformity in all respects with Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

“4” – Acceptable 2 – This grade is given to acceptable loans. These loans have adequate sources of repayment, with little identifiable risk of collection. Loans assigned this risk grade will demonstrate the following characteristics:

- General conformity to the Bank's underwriting requirements, with limited exceptions to the Bank's policy, product or underwriting guidelines. All exceptions noted have documented mitigating factors that offset any additional risk associated with the exceptions noted.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

“5” – Weak Pass – This grade is given to acceptable loans that show signs of weakness in either adequate sources of repayment or collateral, but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Loans assigned this grade may demonstrate some or all of the following characteristics:

- Additional exceptions to the Bank's policy requirements, product guidelines or underwriting standards that present a higher degree of risk to the Bank. Although the combination and/or severity of identified exceptions is greater for this risk grade, the exceptions may be properly mitigated by other documented factors that offset any additional risks.
- Unproved, insufficient or marginal primary sources of repayment that appear sufficient to service the debt at this time. Repayment weaknesses may be due to minor operational issues, financial trends, or reliance on projected (not historic) performance.
- Marginal or unproven secondary sources to liquidate the debt, including combinations of liquidation of collateral and liquidation value to the net worth of the borrower or guarantor.

“6” – Special Mention – Special Mention loans include the following characteristics:

- Loans with underwriting guideline tolerances and/or exceptions and with no mitigating factors;
- Extending loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank's position at some future date. Potential weaknesses are the result of deviations from prudent lending practices; or
- Loans where adverse economic conditions have developed subsequent to the loan origination that do not jeopardize liquidation of the debt, but do substantially increase the level of risk, may also warrant this rating.

“7” – Substandard – A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Loans consistently not meeting the repayment schedule should be downgraded to substandard. Loans in this category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action. The weaknesses may include, but are not limited to:

- High debt to worth ratios
- Declining or negative earnings trends
- Declining or inadequate liquidity
- Questionable repayment sources
- Lack of well-defined secondary repayment source, and
- Unfavorable competitive comparisons.

Such loans are no longer considered to be adequately protected due to the borrower's declining net worth, lack of earnings capacity, declining collateral margins and/or unperfected collateral positions. A possibility of loss of a portion of the loan balance cannot be ruled out. The repayment ability of the borrower is marginal or weak and the loan may have exhibited excessive overdue status or extensions and/or renewals.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

“8” – Doubtful – Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Among these events are:

- Injection of capital
- Alternative financing
- Liquidation of assets or the pledging of additional collateral.

The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

“9” – Loss – Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan even though partial recovery may be effected in the future. Probable Loss portions of problem assets should be charged against the Reserve for Loan Losses. Loans may reside in this classification for administrative purposes for a period not to exceed the earlier of thirty (30) days or calendar quarter-end.

The following is a summary of credit quality indicators by class at December 31, 2013 and 2012:

#### Real Estate Credit Exposure as of December 31, 2013

	Commercial Real Estate						Equity lines of credit
	Construction	Non-owner occupied	Owner occupied	Residential 1-4 Family	Multifamily		
	(in thousands)						
Prime	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	
Good	-	298	175	103	-	537	
Acceptable 1	2,840	5,071	9,944	12,875	115	5,664	
Acceptable 2	7,327	12,937	22,092	13,271	5,164	3,869	
Weak Pass	8,362	13,677	17,573	10,428	1,643	1,064	
Special Mention	8,735	161	872	3,208	-	21	
Substandard	3,997	2,583	7,381	1,454	455	270	
Doubtful	-	-	-	-	-	-	
Loss	-	-	-	-	-	-	
	<u>\$ 31,261</u>	<u>\$ 34,727</u>	<u>\$ 58,037</u>	<u>\$ 41,339</u>	<u>\$ 7,377</u>	<u>\$ 11,425</u>	

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

#### Other Credit Exposures as of December 31, 2013

	Commerical and industrial	Agricultural	Individuals	Total
Prime	\$ -	\$ -	\$ -	\$ -
Good	-	-	-	1,113
Acceptable 1	2,067	3,088	545	42,209
Acceptable 2	12,186	12,998	993	90,837
Weak Pass	7,774	2,302	302	63,125
Special Mention	911	465	401	14,774
Substandard	135	806	-	17,081
Doubtful	-	-	-	-
Loss	-	-	-	-
	<u>\$ 23,073</u>	<u>\$ 19,659</u>	<u>\$ 2,241</u>	<u>\$ 229,139</u>

#### Real Estate Credit Exposure as of December 31, 2012

	Construction	Commercial Real Estate		Residential 14 Family	Multifamily	Equity lines of credit	
		Non-owner occupied	Owner occupied				
		(in thousands)					
Prime	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	
Good	-	385	258	210	-	1,041	
Acceptable 1	3,658	5,172	10,767	16,948	807	5,710	
Acceptable 2	8,409	10,700	22,074	14,399	2,406	2,789	
Weak Pass	9,210	10,255	16,463	6,389	4,164	589	
Special Mention	5,503	1,925	1,879	1,663	-	26	
Substandard	6,759	4,620	5,251	2,696	714	273	
Doubtful	-	-	-	250	-	-	
Loss	-	-	-	-	-	-	
	<u>\$ 33,539</u>	<u>\$ 33,057</u>	<u>\$ 56,692</u>	<u>\$ 42,555</u>	<u>\$ 8,091</u>	<u>\$ 10,428</u>	

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

#### Other Credit Exposures as of December 31, 2012

	Commerical and industrial	Agricultural	Individuals	Total
Prime	\$ -	\$ 1	\$ -	\$ 1
Good	-	-	52	1,946
Acceptable 1	3,063	2,818	534	49,477
Acceptable 2	12,997	7,265	869	81,908
Weak Pass	7,119	7,557	337	62,083
Special Mention	379	724	418	12,517
Substandard	94	172	-	20,579
Doubtful	-	-	3	253
Loss	-	-	-	-
	<u>\$ 23,652</u>	<u>\$ 18,537</u>	<u>\$ 2,213</u>	<u>\$ 228,764</u>

*Nonaccrual loans and past due loans* - Nonperforming assets include loans classified as nonaccrual, foreclosed bank-owned property and loans past due 90 days or more on which interest is still being accrued. There were two financing receivables with total current principal balance of \$352,822 past due over 90 days accruing interest as of December 31, 2013. These two loans were in the process of collection at December 31, 2013 and are expected to be repaid in full. There were no financing receivables past due over 90 days accruing interest as of December 31, 2012. Nonaccrual loans as of December 31, 2013 totaled \$5.6 million, or 2.45% of total loans, compared with \$4.9 million, or 2.14% of total loans, as of December 31, 2012. The Bank aggressively pursues the collection and repayment of all loans. Other nonperforming assets, such as repossessed and foreclosed collateral are aggressively liquidated by the Bank's management. The total number of loans on nonaccrual status as of December 31, 2013 and 2012 was 18 and 15, respectively.

For the years ended December 31, 2013 and 2012, the Bank recognized no interest income on nonaccrual loans. If interest on those loans had been accrued in accordance with the original terms, interest income would have increased by approximately \$181,249 and \$400,000 for the years ended December 31, 2013 and 2012, respectively.

The following is a breakdown of nonaccrual loans as of December 31, 2013 and 2012:

	2013	2012
Mortgage loans on real estate:		
Construction	\$ 2,896,720	\$ 3,200,801
Commercial real estate:		
Non-owner occupied	126,654	450,000
Owner occupied	1,688,240	-
Residential 1-4 family	372,204	1,161,652
Multifamily	455,300	-
Equity lines of credit	76,954	47,632
Commerical and industrial	-	25,018
Agricultural	-	-
Individuals	-	3,097
Total	<u>\$ 5,616,072</u>	<u>\$ 4,888,200</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

Nonaccrual loans and past due loans (concluded) - All classes of loans are considered past due if the required principal and interest income have not been received as of the date such payments were due. The following tables present the Bank's aged analysis of past due loans as of December 31, 2013 and 2012:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Greater Than 90 Days Still Accruing	Total Past Due	Current	Total Loans
(in thousands)							
<b>December 31, 2013</b>							
Mortgage loans on real estate:							
Construction	\$ 162	\$ -	\$ 2,133	\$ -	\$ 2,295	\$ 28,966	\$ 31,261
Commercial real estate:							
Non-owner occupied	-	-	127	-	127	34,600	34,727
Owner occupied	-	179	-	254	433	57,604	58,037
Residential 1-4 family	200	-	-	-	200	41,139	41,339
Multifamily	-	-	455	-	455	6,922	7,377
Equity lines of credit	-	-	25	-	25	11,400	11,425
Commercial and industrial	40	-	-	-	40	23,033	23,073
Agricultural	-	-	-	99	99	19,560	19,659
Individuals	-	-	-	-	-	2,241	2,241
<b>Total</b>	<b>\$ 402</b>	<b>\$ 179</b>	<b>\$ 2,740</b>	<b>\$ 353</b>	<b>\$ 3,674</b>	<b>\$ 225,465</b>	<b>\$ 229,139</b>

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Greater Than 90 Days Still Accruing	Total Past Due	Current	Total Loans
(in thousands)							
<b>December 31, 2012</b>							
Mortgage loans on real estate:							
Construction	\$ 29	\$ -	\$ 179	\$ -	\$ 208	\$ 33,331	\$ 33,539
Commercial real estate:							
Non-owner occupied	482	-	450	-	932	32,125	33,057
Owner occupied	-	-	-	-	-	56,692	56,692
Residential 1-4 family	275	250	772	-	1,297	41,258	42,555
Multifamily	-	-	-	-	-	8,091	8,091
Equity lines of credit	-	-	-	-	-	10,428	10,428
Commercial and industrial	55	-	-	-	55	23,597	23,652
Agricultural	-	-	-	-	-	18,537	18,537
Individuals	-	-	-	-	-	2,213	2,213
<b>Total</b>	<b>\$ 841</b>	<b>\$ 250</b>	<b>\$ 1,401</b>	<b>\$ -</b>	<b>\$ 2,492</b>	<b>\$ 226,272</b>	<b>\$ 228,764</b>



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

*Troubled Debt Restructurings* - In order to maximize the collection of loan balances, the Bank evaluates troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. Loan modifications may be utilized where there is a reasonable chance that an appropriate modification would allow the Bank's customers to continue servicing debt. A loan is a troubled debt restructuring ("TDR") if both of the following exist: 1) a creditor has granted a concession to the debtor, and, 2) the debtor is experiencing financial difficulties. Non-accruing loans that are modified can be placed back on accrual status when both principal and interest are current and it is probable that the Bank will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement and a sustained period of payment performance is demonstrated. Interest on troubled debt restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur and a sustained payment performance period is obtained. For the years ended December 31, 2013 and 2012, the following table presents a breakdown of the types of concession made by loan class:

	Year ended December 31, 2013			Year ended December 31, 2012		
	Pre-Modification Outstanding Number of loans	Recorded Investment	Post- Modification Outstanding Recorded Investment	Pre-Modification Outstanding Number of loans	Recorded Investment	Post- Modification Outstanding Recorded Investment
Extended payment terms						
Mortgage loans on real estate:						
Construction	-	\$ -	\$ -	9	\$ 5,602,459	\$ 5,321,372
Commercial real estate:						
Non-owner occupied	1	1,414,426	1,390,611	1	208,842	208,842
Owner occupied	2	1,712,802	1,701,451	3	4,678,564	4,532,947
Residential 1-4 family	1	115,200	111,110	8	1,466,022	1,364,275
Multifamily	-	-	-	-	-	-
Equity lines of credit	-	-	-	-	-	-
Commercial and industrial	-	-	-	1	-	-
Agricultural	1	750,000	636,008	2	172,110	172,110
Individuals	-	-	-	-	-	-
<b>Total</b>	<b>5</b>	<b>\$ 3,992,428</b>	<b>\$ 3,839,180</b>	<b>24</b>	<b>\$ 12,127,997</b>	<b>\$ 11,599,546</b>

The restructured loans generally include terms to reduce the interest rate and extend payment terms. The Bank did not forgive any principal associated with any of the above loans during 2013. Within the last 12 months, two loans that were restructured in 2012, with a total principal balance of \$919,100 subsequently defaulted and were foreclosed upon. There were no loans that were restructured within the last 12 months during 2012 that subsequently defaulted. These modifications resulted in specific reserves in the Bank's allowance for loan losses of \$195,008 and \$240,968 as of December 31, 2013 and 2012, respectively.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

*Troubled Debt Restructurings (concluded)* - There are three TDRs that are on non-accrual status and have a total current principal balance of \$2.5 million as of December 31, 2013. There were four TDRs that were on non-accrual status and had a total current principal balance of \$3.4 million as of December 31, 2012. Twenty TDRs with a current principal balance of \$9.8 million and twenty-one TDRs with current principal balance of \$8.2 million were considered performing loans and are accruing interest based on their sustained payment performance as of December 31, 2013 and 2012, respectively.

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio.

*Impaired Loans* - Management considers certain loans graded “doubtful” (loans graded 8) or “loss” (loans graded 9) to be individually impaired and may consider “substandard” loans (loans graded 7) individually impaired depending on the borrower’s payment history. The Bank measures impairment based upon discounted probable cash flows or the value of the collateral. Collateral value is assessed based on collateral value trends, liquidation value trends, and other liquidation expenses to determine logical and credible discounts that may be needed. Updated appraisals are required for all impaired loans and typically at renewal or modification of larger loans if the appraisal is more than 12 months old.

Impaired loans for all classes of loans typically include nonaccrual loans, loans over 90 days past due still accruing, troubled debt restructured loans and other potential problem loans considered impaired based on other underlying factors. Potential problem loans totaled \$14.8 million and \$12.5 million as of December 31, 2013 and 2012, respectively. These totals include loans which are currently performing and are not included in nonaccrual or restructured loans above, but about which we have serious doubts as to the borrower’s ability to comply with present repayment terms. These loans are likely to be included later in nonaccrual, past due or troubled debt restructured loans, so they are considered by management in assessing the adequacy of the allowance for loan losses. No additional funds are committed to be advanced in connection with impaired loans.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

The following tables present the Bank's investment in loans considered to be impaired and related information on those impaired loans as of December 31, 2013 and 2012:

	Recorded Investment	Unpaid Principal Balance	Related Allowance (in thousands)	Year to Date	
				Average Recorded Investment	Interest Income Recognized
<b>December 31, 2013</b>					
<b>Impaired loans without a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Construction	\$ 1,431	\$ 1,504	\$ -	\$ 1,942	\$ 107
Commercial real estate:					
Non-owner occupied	2,583	2,583	-	2,623	168
Owner occupied	3,504	3,504	-	3,709	193
Residential 1-4 family	897	897	-	929	45
Multifamily	455	682	-	700	8
Equity lines of credit	239	239	-	244	8
Commercial and industrial	-	-	-	-	-
Agricultural	170	170	-	172	13
Individuals	-	-	-	-	-
<b>Impaired loans with a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Construction	2,567	2,567	659	2,584	92
Commercial real estate:					
Non-owner occupied	-	-	-	-	-
Owner occupied	3,877	3,877	568	3,942	186
Residential 1-4 family	557	557	113	572	30
Multifamily	-	-	-	-	-
Equity lines of credit	30	30	30	31	-
Commercial and industrial	135	135	4	84	3
Agricultural	636	636	195	711	44
Individuals	-	-	-	-	-
<b>Total impaired loans</b>					
Mortgage loans on real estate:					
Construction	\$ 3,998	\$ 4,071	\$ 659	\$ 4,526	\$ 199
Commercial real estate:					
Non-owner occupied	2,583	2,583	-	2,623	168
Owner occupied	7,381	7,381	568	7,651	379
Residential 1-4 family	1,454	1,454	113	1,501	75
Multifamily	455	682	-	700	8
Equity lines of credit	269	269	30	275	8
Commercial and industrial	135	135	4	84	3
Agricultural	806	806	195	883	57
Individuals	-	-	-	-	-
<b>Total impaired loans</b>	<b>\$ 17,081</b>	<b>\$ 17,381</b>	<b>\$ 1,569</b>	<b>\$ 18,243</b>	<b>\$ 897</b>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

	Recorded Investment	Unpaid Principal Balance	Related Allowance (in thousands)	Year to Date	
				Average Recorded Investment	Interest Income Recognized
<b>December 31, 2012</b>					
<b>Impaired loans without a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Construction	\$ 5,972	\$ 5,972	\$ -	\$ 5,932	\$ 376
Commercial real estate:					
Non-owner occupied	3,463	4,014	-	4,060	223
Owner occupied	2,527	2,527	-	2,569	151
Residential 1-4 family	1,688	1,760	-	1,800	88
Multifamily	75	75	-	77	5
Equity lines of credit	225	449	-	227	10
Commercial and industrial	14	14	-	30	2
Agricultural	172	172	-	173	12
Individuals	-	-	-	-	-
<b>Impaired loans with a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Construction	788	862	120	875	38
Commercial real estate:					
Non-owner occupied	1,158	1,158	78	1,184	72
Owner occupied	2,723	2,723	87	2,769	106
Residential 1-4 family	1,257	1,257	445	947	56
Multifamily	639	639	229	645	42
Equity lines of credit	48	97	38	50	1
Commercial and industrial	80	80	65	94	6
Agricultural	-	-	-	-	-
Individuals	3	3	3	5	1
<b>Total impaired loans</b>					
Mortgage loans on real estate:					
Construction	\$ 6,760	\$ 6,834	\$ 120	\$ 6,807	\$ 414
Commercial real estate:					
Non-owner occupied	4,621	5,172	78	5,244	295
Owner occupied	5,250	5,250	87	5,338	257
Residential 1-4 family	2,945	3,017	445	2,747	144
Multifamily	714	714	229	722	47
Equity lines of credit	273	546	38	277	11
Commercial and industrial	94	94	65	124	8
Agricultural	172	172	-	173	12
Individuals	3	3	3	5	1
<b>Total impaired loans</b>	<b>\$ 20,832</b>	<b>\$ 21,802</b>	<b>\$ 1,065</b>	<b>\$ 21,437</b>	<b>\$ 1,189</b>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

*Allowance for Loan Losses* - The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate for probable losses that have been incurred within the existing portfolio of loans. The primary risks inherent in the Bank's loan portfolio, including the adequacy of the allowance or reserve for loan losses, are based on management's assumptions regarding, among other factors, general and local economic conditions, which are difficult to predict and are beyond the Bank's control. In estimating these risks, and the related loss reserve levels, management also considers the financial conditions of specific borrowers and credit concentrations with specific borrowers, groups of borrowers, and industries.

The allowance for loan losses is adjusted by direct charges to provision expense. Losses on loans are charged against the allowance for loan losses in the accounting period in which they are determined by management to be uncollectible. Recoveries during the period are credited to the allowance for loan losses. The Bank realized negative provisions of \$500,000 for the year ended December 31, 2013. There was no provision for loan losses for the year ended December 31, 2012. During 2012 the Bank received several large recoveries, which were credited to the allowance. The recoveries and the continued improvement in our credit related trends were the main contributors to the negative provisions in 2013 and no provision for loan losses during 2012. The provision expense is determined by the Bank's allowance for loan losses model. The components of the model are specific reserves for impaired loans and a general allocation for unimpaired loans. The general allocation has three components, an estimate based on historical loss experience, an additional estimate based on internal and external environmental factors due to the uncertainty of historical loss experience in predicting current embedded losses in the portfolio that will be realized in the future and an unallocated portion to cover uncertainties that could affect management's estimate of probable losses.

In determining the general allowance allocation, the ratios from the actual loss history for the various categories are applied to the homogeneous pools of loans in each category. During 2012 management increased the historical look back period included in its allowance for losses on loans estimation. Management determined increasing the look back period from eight to twelve quarters was more reflective of the Bank's historical loss experience in order to estimate losses inherent in the loan portfolio. The impact of this change in estimation was an increase in the reserve of \$1.4 million during 2012.

The portion of the general allocation on environmental factors includes estimates of losses related to the following:

- Current national and local economic conditions
- Composition of the nature and volume of the portfolio
- Changes in the trend or volume of past due, watch list and classified loans
- The existence and effect of concentrations or changes in concentrations upon the portfolio
- The existence and effect of granularity in the size of credits in the portfolio
- The existence and effect of loan to values in excess of regulatory guidance - percentage of loans in each category with Reg H exceptions
- Cumulative effect of other factors such as loan portfolio quality, underwriting strength and general determinations about the portfolio held by executive management.

Markets served by the Bank continue to experience softening from the general economy and declines in real estate values. Other factors impacting the allowance at December 31, 2013 were watch list trends, unemployment rate trends, government spending expectations and underwriting and servicing assessments.

During 2011 the Bank charged-off approximately \$1.9 million of principal on a construction loan of \$3.4 million due to the deteriorating financial condition of the borrower and a current appraisal on the collateral. In 2012 the Bank entered into an agreement to sell this note to a third party for \$2 million. This transaction resulted in a recovery of approximately \$714,000 which increased the Bank's allowance for loan losses and is included in recoveries on construction loans in the 2012 table below.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (continued)

Allowance for Loan Losses (continued) - The following tables present changes in the allowance for loan losses for the years ended December 31, 2013 and 2012:

	December 31, 2012	Charge-offs	Recoveries	Provision	December 31, 2013
	(Amounts in thousands)				
Mortgage loans on real estate:					
Construction	\$ 2,137	\$ 250	\$ 23	\$ (312)	\$ 1,598
Commercial real estate:					
Non-owner occupied	925	-	-	(32)	893
Owner occupied	1,227	-	-	501	1,728
Residential 1-4 family	1,962	129	37	(370)	1,500
Multifamily	354	227	-	63	190
Equity lines of credit	301	5	17	(21)	292
Commercial and industrial	1,138	18	7	(537)	590
Agricultural	335	-	-	215	550
Individuals	44	2	5	(7)	40
	<u>\$ 8,423</u>	<u>\$ 631</u>	<u>\$ 89</u>	<u>\$ (500)</u>	<u>\$ 7,381</u>

	December 31, 2011	Charge-offs	Recoveries	Provision	December 31, 2012
	(Amounts in thousands)				
Mortgage loans on real estate:					
Construction	\$ 3,842	\$ 72	\$ 807	\$ (2,440)	\$ 2,137
Commercial real estate:					
Non-owner occupied	678	551	67	731	925
Owner occupied	883	-	-	344	1,227
Residential 1-4 family	1,665	790	293	794	1,962
Multifamily	56	-	-	298	354
Equity lines of credit	269	40	16	56	301
Commercial and industrial	1,302	132	14	(46)	1,138
Agricultural	93	-	-	242	335
Individuals	27	4	-	21	44
	<u>\$ 8,815</u>	<u>\$ 1,589</u>	<u>\$ 1,197</u>	<u>\$ -</u>	<u>\$ 8,423</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 4 - Loans and Allowance for Loan Losses (concluded)

Allowance for Loan Losses (concluded) - The activity in the allowance for loan loss for 2013 and 2012 are summarized by loan class as follows:

As of December 31, 2013	Reserves for loans individually evaluated for impairment	Loans individually evaluated for impairment	Reserves for loans collectively evaluated for impairment	Loans collectively evaluated for impairment
	(Amounts in thousands)			
Mortgage loans on real estate:				
Construction	\$ 659	\$ 3,998	\$ 939	\$ 27,263
Commercial real estate:				
Non owner occupied	-	2,583	893	32,144
Owner occupied	568	7,381	1,160	50,656
Residential 1-4 family	113	1,454	1,387	39,885
Multifamily	-	455	190	6,922
Equity lines of credit	30	269	262	11,156
Commercial and industrial	4	135	586	22,938
Agricultural	195	806	355	18,853
Individuals	-	-	40	2,241
	<u>\$ 1,569</u>	<u>\$ 17,081</u>	<u>\$ 5,812</u>	<u>\$ 212,058</u>

As of December 31, 2012	Reserves for loans individually evaluated for impairment	Loans individually evaluated for impairment	Reserves for loans collectively evaluated for impairment	Loans collectively evaluated for impairment
	(Amounts in thousands)			
Mortgage loans on real estate:				
Construction	\$ 120	\$ 6,760	\$ 2,017	\$ 26,779
Commercial real estate:				
Non owner occupied	78	4,621	847	28,436
Owner occupied	87	5,250	1,140	51,442
Residential 1-4 family	445	2,945	1,517	39,610
Multifamily	229	714	125	7,377
Equity lines of credit	38	273	263	10,155
Commercial and industrial	65	94	1,073	23,558
Agricultural	-	172	335	18,365
Individuals	3	3	41	2,210
	<u>\$ 1,065</u>	<u>\$ 20,832</u>	<u>\$ 7,358</u>	<u>\$ 207,932</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 5 - Premises and equipment

At December 31, 2013 and 2012, premises and equipment consist of the following:

	2013	2012
Land	\$ 1,666,727	\$ 1,666,727
Buildings	5,594,344	5,370,026
Equipment, furniture and fixtures	2,685,561	2,205,990
Computer equipment	302,841	302,841
Software	463,176	451,125
	<u>10,712,649</u>	<u>9,996,709</u>
Less accumulated depreciation	(5,696,414)	(5,247,629)
Construction in progress	21,931	-
Total premises and equipment, net	<u>\$ 5,038,166</u>	<u>\$ 4,749,080</u>

For 2013 and 2012, depreciation charged to operating expense was \$448,786 and \$438,944, respectively.

During 2012, the Bank sold a parcel of land resulting in a gain of \$842,513.

### Note 6 - Non-marketable equity securities

Non-marketable equity securities consist of the following at December 31, 2013 and 2012:

	2013	2012
Federal Home Loan Bank stock	\$ 1,371,300	\$ 1,535,700
Federal Reserve Bank stock	273,900	360,250
Community Bankers' Bank stock	61,300	61,300
Bankers Title, LLC	49,589	49,589
Senior Housing Crime Prevention Foundation stock	500,000	500,000
Total non-marketable equity securities	<u>\$ 2,256,089</u>	<u>\$ 2,506,839</u>

### Note 7 - Interest-bearing deposits

Interest-bearing deposits consist of the following:

	2013	2012
NOW accounts	\$ 31,415,299	\$ 28,379,608
Money market accounts	89,663,359	68,840,024
Savings accounts	21,580,454	21,414,822
Certificates of deposits and IRAs \$100,000 and over	49,470,689	56,496,579
Certificates of deposits and IRAs under \$100,000	80,181,041	93,288,401
Total interest-bearing deposits	<u>\$ 272,310,842</u>	<u>\$ 268,419,434</u>



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 7 - Interest-bearing deposits (concluded)

At December 31, 2013, the scheduled maturities of time deposits are as follows:

2014	\$	48,397,834
2015		27,856,759
2016		22,034,195
2017		11,443,102
2018		19,919,840
Thereafter		-
Total time deposits	\$	<u>129,651,730</u>

### Note 8 - Capital notes

During the fourth quarter of 2013, the Company closed the private placement of unregistered debt securities (the "2013 Offering") pursuant to which the Company issued approximately \$11.3 million in principal of notes (the "2013 Notes"). The 2013 Notes have not been and will not be registered under the Securities Act of 1933 and may not be offered or sold in the United States absent registration or an applicable exemption from registration requirements. The 2013 Notes bear interest at the rate of 5% per year with interest payable quarterly in arrears. The 2013 Notes mature on December 31, 2018, but are subject to prepayment in whole or in part on or after December 31, 2014 at the Company's sole discretion on 30 days written notice to the holders. There are no assets pledged as collateral for the 2013 Notes. The Company used approximately \$6.2 million of the proceeds from the 2013 Offering in December to repay the funds associated with the United States Treasury's Capital Purchase Program (see Note 20).

Of these capital notes, \$900,000 is due to executive officers and board members of the Bank as of December 31, 2013. Interest expense of \$3,375 was paid to these related parties on the capital notes for the year ended December 31, 2013.

### Note 9 - Securities sold under agreements to repurchase and other borrowings

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one day from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction.

Information concerning securities sold under agreements to repurchase is summarized, as follows:

	2013	2012
Balance at December 31,	\$ 2,595,776	\$ 1,747,780
Average balance during the year	\$ 2,160,045	\$ 1,636,172
Average interest rate during the year	0.25%	0.25%
Maximum month-end balance during the year	\$ 3,148,511	\$ 2,736,487

The Bank has arrangements with various banks which enables the Bank to borrow up to \$30,000,000 in federal funds on an unsecured basis, at a variable rate. At December 31, 2013 and 2012, the Bank had outstanding federal funds purchased in the amount of \$-0-.

The Bank also has arrangements with the Federal Home Loan Bank which enables the Bank to borrow up to twenty-five percent of total assets.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 9 - Securities sold under agreements to repurchase and other borrowings (concluded)

At December 31, 2013 and 2012, Federal Home Loan Bank advances were as follows:

#### December 31, 2013

Maturity date	Call Feature	Amount	Rate
September 2, 2014	-	\$ 5,000,000	1.963%
August 31, 2015	-	5,000,000	3.080%
May 29, 2018	One-time call	5,000,000	3.690%
January 8, 2014	-	5,000,000	0.280%
Total FHLB borrowings/weighted average rate		<u>\$ 20,000,000</u>	2.253%

#### December 31, 2012

Maturity date	Call Feature	Amount	Rate
July 8, 2013	-	\$ 5,000,000	1.380%
September 2, 2014	-	5,000,000	1.963%
August 31, 2015	-	5,000,000	3.080%
May 29, 2018	One-time call	5,000,000	3.690%
Total FHLB borrowings/weighted average rate		<u>\$ 20,000,000</u>	2.530%

The carrying value of loans pledged as collateral to the Federal Home Loan Bank were \$31,964,545 and \$66,322,974 at December 31, 2013 and 2012, respectively.

During 2012, the Bank prepaid \$20 million in FHLB advances with a weighted average rate of 3.04%. These advances were paid prior to their maturity date in order to enhance future earnings by way of reduction in interest expense. These repayments resulted in a prepayment penalty on borrowings equaling \$557,523.

### Note 10 - Employee benefit plans

*Profit sharing plan* - The Company has a profit sharing plan covering substantially all employees. Contributions to the plan are determined annually by the Compensation Committee and are the lesser of 10% of the participants' base compensation or 10% of the net income of the Bank. Employee benefits expense included \$335,000 and \$315,000 for the plan for 2013 and 2012, respectively.

*Post-retirement benefits* - The Company has entered into deferred compensation arrangements with certain key personnel which call for the payment of benefits upon the retirement or death of the individuals. These arrangements are funded through life insurance policies on the individuals, with the intent that the proceeds from the life insurance policies approximate amounts payable under the deferred compensation arrangements. The liabilities associated with these deferred compensation arrangements were \$971,455 and \$753,184 as of December 31, 2013 and 2012, respectively. Salaries and employee benefits expense included \$221,811 and \$115,736 of expense related to these arrangements for 2013 and 2012, respectively.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 11 - Income taxes

The principal components of the income tax expense as of December 31, 2013 and 2012 are as follows:

	2013	2012
Federal - current tax provision	\$ 577,413	\$ 904,129
Federal - deferred	520,557	406,105
	<u>\$ 1,097,970</u>	<u>\$ 1,310,234</u>

The differences between expected federal income taxes at statutory rates and actual income tax expense are summarized as follows:

	2013	2012
Income tax expense computed at federal statutory rate (34%)	\$ 1,500,663	\$ 1,714,127
Tax effects of:		
Tax-exempt interest	(448,919)	(415,876)
Non-deductible expenses	20,776	13,470
Other	25,450	(1,487)
	<u>\$ 1,097,970</u>	<u>\$ 1,310,234</u>

The Bank's deferred tax assets and liabilities and their components are included in other assets and liabilities on the balance sheets. The components of these deferred tax assets and liabilities are as follows:

	2013	2012
Deferred tax assets:		
Allowance for loan losses	\$ 1,363,456	\$ 1,786,428
Deferred compensation	338,248	262,832
Interest on non-performing loans	26,246	118,213
Write-down of value related to other real estate owned	296,570	291,820
Other	43,416	11,375
Total deferred tax asset	<u>2,067,936</u>	<u>2,470,668</u>
Deferred tax liabilities:		
Accumulated accretion on available-for-sale investment securities	(130,727)	(127,233)
Accumulated depreciation	(366,845)	(260,610)
Net unamortized deferred fees and expenses	(29,006)	(20,908)
Net unrealized gain on available-for-sale securities	(484,973)	(2,323,463)
Total deferred tax liability	<u>(1,011,551)</u>	<u>(2,732,214)</u>
Net deferred tax asset (liability)	<u>\$ 1,056,385</u>	<u>\$ (261,546)</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 11 - Income taxes (concluded)

In evaluating whether the Bank will realize the full benefit of its net deferred tax asset, it considers both positive and negative evidence, including recent earnings trends and projected earnings, asset quality, etc. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. Positive evidence considered by the Bank includes a long history of earnings and expected continued earnings in 2014 given the improvement in credit quality metrics. Credit quality metrics during 2013, such as the adversely classified assets ratio, net charge-offs as a percent of loans and nonaccrual loan balances continually improved providing further positive evidence. As a result, the Bank has concluded that no valuation allowance is deemed necessary at this time.

### Note 12 - Commitments and contingencies

The Company leases banking premises and various equipment for periods extending through December 2017. Total rental expense was \$187,351 and \$122,327 for 2013 and 2012, respectively.

Pursuant to the terms of non-cancelable lease agreements in effect at December 31, 2013, pertaining to bank premises and equipment, future minimum rental commitments under various operating leases are as follows:

2014	\$	125,765
2015		111,109
2016		90,939
2017		5,002
2018		-
	\$	<u>332,815</u>

Various legal claims also arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

### Note 13 - Related party transactions

In the ordinary course of business, the Bank has loan and deposit transactions with its executive officers and directors, and with companies in which the officers and directors have a significant financial interest. These transactions are at substantially the same rates as similarly situated customers. A summary of related party loan activity during 2013 and 2012 is as follows:

	<u>2013</u>	<u>2012</u>
Beginning balance, January 1	\$ 2,508,622	\$ 3,121,031
Originations	1,649,450	378,767
Repayments	(564,499)	(991,176)
Ending balance, December 31,	<u>\$ 3,593,573</u>	<u>\$ 2,508,622</u>

Commitments to extend credit to related parties amounted to \$7,557,701 and \$5,836,917 at December 31, 2013 and 2012, respectively.

Deposits from related parties held by the Bank amounted to \$8,212,635 and \$5,240,773 at December 31, 2013 and 2012, respectively.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 14 - Credit commitments and concentrations of credit risk

Commitments to extend credit are agreements to lend funds to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer. Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized, usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year.

The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary.

The amounts of loan commitments, guarantees and standby letters of credit are set out in the following table as of December 31, 2013 and 2012. Because many commitments and almost all standby letters of credit and guarantees expire without being funded in whole or in part, the contract amounts are not estimates of future cash flows. A summary of loan commitments and standby letters of credit is as follows:

	2013	2012
Loan commitments	\$ 51,266,040	\$ 46,508,908
Standby letters of credit and guarantees written	\$ 400,566	\$ 487,527

Standby letters of credit outstanding at December 31, 2013 expire during 2014.

Loan commitments, standby letters of credit and written guarantees have off-balance sheet credit risk because only origination fees and accruals for probable losses, if any, are recognized in the statements of financial position until the commitments are fulfilled or the standby letters of credit or guarantees expire. Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. The credit risk amounts are equal to the contractual amounts, assuming that the amounts are fully advanced and collateral or other security is of no value. The Bank's policy is to require customers to provide collateral prior to the disbursement of approved loans. For retail loans, the Bank usually retains a security interest in the property or products financed, which provides repossession rights in the event of default by the customer. For business loans and financial guarantees, collateral is usually in the form of inventory or marketable securities (held in trust) or property (notations on title).

Concentrations of credit risk (whether on or off-balance sheet) arising from financial instruments exist in relation to certain groups of customers. A group concentration arises when a number of counterparties have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. A group concentration exists as most of the Bank's customers are located within southeastern Virginia.

The credit risk amounts represent the maximum accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted and any collateral or security proved to be of no value. The Bank has experienced little difficulty in accessing collateral when required.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 15 - Regulatory matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

Management believes, as of December 31, 2013, the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2013, the most recent notification from the Board of Governors of the Federal Reserve Board categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts (dollars in thousands) and ratios are presented in the table below:

	Actual		For Capital Adequacy Purposes		Under Prompt Corrective Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>						
As of December 31, 2013:						
Total Capital						
(to Risk-Weighted Assets)	\$ 45,294	18.4%	\$ 19,697	8%	\$ 24,622	10%
Tier I Capital						
(to Risk-Weighted Assets)	42,163	17.1%	9,849	4%	14,773	6%
Tier I Capital						
(to Average Assets)	42,163	10.4%	16,270	4%	20,338	5%
As of December 31, 2012:						
Total Capital						
(to Risk-Weighted Assets)	\$ 41,508	17.5%	\$ 18,967	8%	\$ 23,709	10%
Tier I Capital						
(to Risk-Weighted Assets)	38,482	16.2%	9,483	4%	14,225	6%
Tier I Capital						
(to Average Assets)	38,482	9.5%	16,122	4%	20,152	5%

The above tables set forth the capital position and analysis for the Bank only. Because total assets on a consolidated basis are less than \$500 million, the Company is not subject to the consolidated capital requirements imposed by the Bank Holding Company Act. Consequently, the Company does not calculate its financial ratios on a consolidated basis. If calculated, the capital ratios for the Company on a consolidated basis would no longer be comparable to the capital ratios of the Bank because the proceeds of the capital notes do not qualify as equity capital on a consolidated basis.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 16 - Fair value measurements

The Company refers to the *Fair Value Measurements and Disclosures* Topic of the FASB Accounting Standards Codification (ASC 820) to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. This guidance clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

The fair market value measurement specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions.

The three levels of the fair value hierarchy are based on these two types of inputs are as follows:

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 - Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 - Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

*Securities available for sale* - Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

The following table presents the balances of available-for-sale securities measured at fair value on a recurring basis as of December 31, 2013 and 2012:

Description	Balance as of			
	December 31, 2013	Level 1	Level 2	Level 3
State and municipal	\$ 35,658,569	\$ -	\$ 35,658,569	\$ -
Residential mortgage-backed securities	19,073,420	-	19,073,420	-
Collateralized mortgage obligations	46,290,708	-	46,290,708	-
Small Business Administration Pools	39,270,621	-	39,270,621	-
	<u>\$ 140,293,318</u>	<u>\$ -</u>	<u>\$ 140,293,318</u>	<u>\$ -</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 16 - Fair value measurements (continued)

Description	Balance as of December 31, 2012	Level 1	Level 2	Level 3
State and municipal	\$ 32,438,699	\$ -	\$ 32,438,699	\$ -
Residential mortgage-backed securities	16,134,963	-	16,134,963	-
Collateralized mortgage obligations	40,172,113	-	40,172,113	-
Small Business Administration Pools	46,802,082	-	46,802,082	-
	<u>\$ 135,547,857</u>	<u>\$ -</u>	<u>\$ 135,547,857</u>	<u>\$ -</u>

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain financial assets recorded at fair value on a nonrecurring basis in the consolidated financial statements:

*Impaired Loans* - Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on the observable market price of the loan, the fair value of the collateral or by using the discounted cash flow method. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate.

The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company. The Company records impaired loans secured by real estate as Level 3 assets. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports are recorded as Level 3 assets. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Operations.

*Other real estate owned* - Other real estate owned is considered held for sale and is adjusted to fair value less estimated selling costs upon transfer of the loan to foreclosed assets. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. The Company considers the other real estate owned as nonrecurring Level 3.

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis during the periods.

Description	Balance as of December 31, 2013	Level 1	Level 2	Level 3
Assets				
Other real estate owned	\$ 616,000	\$ -	\$ -	\$ 616,000
Impaired loans	6,232,267	-	-	6,232,267
Total assets	<u>\$ 6,848,267</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,848,267</u>



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 16 - Fair value measurements (concluded)

Description	Balance as of			
	December 31, 2012	Level 1	Level 2	Level 3
Assets				
Other real estate owned	\$ 445,020	\$ -	\$ -	\$ 445,020
Impaired loans	5,632,314	-	-	5,632,314
Total assets	<u>\$ 6,077,334</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,077,334</u>

The following table summarized quantitative information about Level 3 fair value measurements:

Description	Fair Value at			Range (Weighted Average)
	December 31, 2013	Valuation Technique	Unobservable Input	
Assets				
Other real estate owned	\$ 616,000	Discounted appraisals	Collateral discounts	10-20%
Impaired loans	6,232,267	Discounted appraisals	Collateral discounts	10-30%
		Discounted cash flows	Discount rate	6%
Total assets	<u>\$ 6,848,267</u>			

Description	Fair Value at			Range (Weighted Average)
	December 31, 2012	Valuation Technique	Unobservable Input	
Assets				
Other real estate owned	\$ 445,020	Discounted appraisals	Collateral discounts	10-20%
Impaired loans	5,632,314	Discounted appraisals	Collateral discounts	10-20%
		Discounted cash flows	Discount rate	6%
Total assets	<u>\$ 6,077,334</u>			

The following table presents the carrying amounts and fair value of the Company's financial instruments as of December 31, 2013 and 2012. FASB Accounting Standards Codification's *Financial Instruments* (ASC 825), defines the fair value of financial instruments as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The carrying amounts in the table are included in the balance sheets under the indicated captions.

	2013		2012	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
(Dollars in thousands)				
Financial assets:				
Cash and cash equivalents	\$ 31,511	\$ 31,511	\$ 19,451	\$ 19,451
Investment securities, available-for-sale	140,293	140,293	135,548	135,548
Loans, net	221,843	221,561	220,402	221,723
Accrued interest receivable	1,797	1,797	1,831	1,831
Financial liabilities:				
Demand deposits, NOW, savings and money market accounts	213,699	213,699	175,895	175,895
Time deposits	129,652	131,899	149,785	153,522
Accrued interest payable	234	234	326	326
FHLB Advances	20,000	20,751	20,000	21,196
Securities sold under agreement to repurchase	2,596	2,596	1,748	1,748

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 17 - Stock incentive plan

The Board approved a stock incentive plan effective January 1, 2007. The plan authorizes the grant of awards for a period of ten years. The number of shares authorized for issuance under the plan is limited to 2.25% of the total authorized and unissued shares of common stock. Three types of awards may be granted under the plan: Incentive Stock Options, Nonqualified Stock Options and Restricted Stock.

The Bank granted restricted stock awards during 2007, 2008 and 2010. The Bank accounts for this plan in accordance with the *Stock Compensation* Topic of the FASB Accounting Standards Codification (ASC 718). The non-vested equity share or non-vested equity share unit awarded to an employee is measured at its fair value on the grant date. The compensation expense is recognized over the requisite service period.

The fair value of the shares of restricted stock was determined by an outside appraisal. The vesting requirements range from 1 to 5 years. The compensation expense recognized for the years ended December 31, 2013 and 2012 was \$15,001 and \$15,000, respectively. Members of the Board of Directors of the Bank can elect to receive a portion or all of their director's fees in the form of common stock. During the year ended December 31, 2013 and 2012, the expense related to these issuances was \$28,500 and \$24,500, respectively.

A summary of the status of the non-vested shares in relation to our restricted stock awards as of December 31, 2013 and 2012, and changes during the years ended December 31, 2013 and 2012, is presented below; the weighted average price is the weighted average fair value at the date of grant:

Restricted Share Awards	2013		2012	
	Shares	Weighted Average Price	Shares	Weighted Average Price
Nonvested - Beginning of the year	420	\$ 35.75	840	\$ 35.75
Granted	-	-	-	-
Vested	(420)	35.75	(420)	35.75
Forfeited	-	-	-	-
Nonvested - End of year	-	\$ -	420	\$ 35.75

### Note 18 - Earnings per share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock. Potential dilutive common stock had no effect on income attributable to common shareholders.

	2013	2012
<b>Basic</b>		
Net income, as reported	\$ 3,315,744	\$ 3,731,315
Preferred stock dividends and accretion of discount	488,399	570,257
Net income attributable to common shareholders	<u>\$ 2,827,345</u>	<u>\$ 3,161,058</u>
Average common shares outstanding	<u>607,357</u>	<u>605,821</u>
Basic earnings per share amount	<u>\$ 4.66</u>	<u>\$ 5.22</u>
<b>Diluted</b>		
Net income attributable to common shareholders	<u>\$ 2,827,345</u>	<u>\$ 3,161,058</u>
Average common shares outstanding	607,357	605,821
Effect of dilutive unvested restricted stock awards	-	-
Average diluted shares outstanding	<u>607,357</u>	<u>605,821</u>
Diluted earnings per share	<u>\$ 4.66</u>	<u>\$ 5.22</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 19 – Condensed financial statements of parent company

On July 26, 2013, the Board of Directors of the Bank approved an Agreement and Plan of Reorganization and Share Exchange (the “Agreement”) whereby the Bank would become a subsidiary of Farmers Bankshares, Inc., a company incorporated in Virginia on July 26, 2013 for the purpose of becoming a holding company for the Bank. The Agreement provided for the statutory share exchange of all of the Bank’s common stock held by stockholders for the common stock of Farmers Bankshares, Inc., on a one-for-one basis.

The Agreement was approved by the Bank’s stockholders at a special meeting of the Bank’s stockholders held on September 26, 2013 (the “Special Stockholders’ Meeting”). The holding company reorganization was consummated on December 31, 2013. Prior to the holding company reorganization, Farmers Bankshares, Inc. conducted no operations other than obtaining regulatory approval for the holding company reorganization. As this event is considered reorganization under common control, the consolidated financial statements, discussion of the statements and all other information presented herein for the year ending December 31, 2013 are presented for the Company as a consolidated entity.

Financial information pertaining only to Farmers Bankshares, Inc. is as follows:

### Balance Sheet

	<u>December 31,</u> <u>2013</u>
<b>Assets</b>	
Cash	\$ 1,042,892
Taxes receivable	14,348
Investment in Farmers Bank	43,104,139
Other assets	190,863
<b>Total assets</b>	<u>\$ 44,352,242</u>
<b>Liabilities and Stockholders' Equity</b>	
<b>Liabilities</b>	
Capital notes, 5% due December 31, 2018	\$ 11,253,475
Other liabilities	228,250
<b>Total liabilities</b>	<u>11,481,725</u>
<b>Stockholders' equity</b>	
Common stock, \$0.625 par value	380,015
Capital surplus	2,695,613
Retained earnings	28,853,472
Accumulated other comprehensive income	941,417
<b>Total stockholders' equity</b>	<u>32,870,517</u>
<b>Total liabilities and stockholders' equity</b>	<u>\$ 44,352,242</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 19 – Condensed financial statements of parent company (concluded)

#### Statements of Operations

	<u>Year Ended</u> <u>December 31, 2013</u>
<b>Income</b>	\$ 170,246
<b>Operating expenses</b>	
Interest expense	42,201
Legal and professional fees	23,125
Other expenses	14,260
<b>Total expenses</b>	<u>79,586</u>
<b>Allocated income tax benefits</b>	(14,348)
<b>Income before equity in undistributed income of subsidiary</b>	<u>105,008</u>
<b>Equity in undistributed income - Farmers Bank</b>	3,210,736
<b>Net income</b>	<u>\$ 3,315,744</u>

#### Statement of Cash Flows

	<u>Year Ended</u> <u>December 31, 2013</u>
<b>Cash flows from operating activities</b>	
Net income	\$ 3,315,744
Adjustments to reconcile net income to net cash provided by operating activities	
Taxes receivable	(14,348)
Other assets	(190,863)
Other liabilities	58,004
Equity in undistributed net income of Farmers Bank	(3,210,736)
<b>Net cash used in operating activities</b>	<u>(42,199)</u>
<b>Cash flows from investing activities</b>	
Investment in Farmers Bank	(4,000,000)
<b>Net cash used in investing activities</b>	<u>(4,000,000)</u>
<b>Cash flows from financing activities</b>	
Proceeds from issuance of 5% capital notes due December 31, 2018	11,253,475
Repurchase of preferred stock	(6,127,000)
Cash dividends paid on preferred shares	(41,384)
<b>Net cash provided by financing activities</b>	<u>5,085,091</u>
<b>Increase in cash and cash equivalents</b>	1,042,892
<b>Cash and cash equivalents</b>	
Beginning of the year	<u>-</u>
End of year	<u>\$ 1,042,892</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2013 and 2012

### Note 20 – Capital Purchase Program (“CPP”)

On January 23, 2009, the Bank issued 8,752 shares of non-cumulative perpetual preferred stock (“Series A”) for \$9.2 million and 438 warrants to the U.S Treasury as a condition to its participation in the Capital Purchase Program (“CPP”). The warrants were exercised immediately upon the issuance of the Series A preferred stock, which resulted in the issuance of 438 shares of non-cumulative perpetual preferred stock (“Series B”). Proceeds from this sale of preferred stock are used for general corporate purposes, including supporting the continued, anticipated growth of the Bank.

On January 9, 2013, the Bank redeemed thirty-five percent, or 3,063 of the total 8,752 shares of its Series A Preferred Stock. The Bank paid \$3,085,973 to redeem this portion of the Series A Preferred Stock, consisting of \$3,063,000 in liquidation value and \$22,973 of accrued and unpaid dividends associated with the preferred stock being redeemed.

During the fourth quarter of 2013, the Company received approval from the Treasury and its federal regulator to redeem the Preferred Stock issued to the Treasury. On December 31, 2013, the Bank redeemed the remaining preferred stock, or 5,689 shares of Series A Preferred Stock and 438 shares of Series B Preferred Stock. The Bank paid \$6,168,383 to redeem this portion of the Series A and Series B Preferred Stock, consisting of \$6,127,000 in liquidation value and \$41,383 of accrued and unpaid dividends associated with the preferred stock being redeemed.

### Note 21 – Subsequent events

The Company has evaluated subsequent events through February 20, 2014, in connection with the preparation of these financial statements which is the date the financial statements were available to be issued.

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# Branch Locations

[www.farmersbankva.com](http://www.farmersbankva.com) • 757-242-6111



J H Lee & Sons, Inc.

## **Courtland**

28319 Southampton Parkway, Suite D



River Stone Chophouse

## **Harbour View – Suffolk**

6255 College Drive, Suite L



Nansemond River Golf Club

## **Hillpoint – Suffolk**

3100 Godwin Boulevard



Harper's Table

## **Lakeside – Suffolk**

1008 West Washington Street



Smithfield Station

## **Smithfield**

1119 South Church Street, PO Box 888



Cotton Harvest

## **Windsor**

50 East Windsor Boulevard, PO Box 285



# FARMERS BANK

[www.farmersbankva.com](http://www.farmersbankva.com)